United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-4163

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SECOND CIRCUIT

G. DOUGLAS BURCK and MARJORIE W.BURCK, Petitioners - Appellants -VS. COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellee	Docket No. 75-4163

APPEAL FROM DECISION OF THE TAX COURT

REPLY BRIEF FOR APPELLANTS

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Of Counsel:

Magill, Badger, Fisher, Cohen & Barnett
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REPLY BRIEF FOR APPFLLANTS

The Commissioner's Brief is well written and articulate, but it says only one thing - the Commissioner is never wrong, the Tax Court has so stated, and this Court should lend its support. This is not the law, as we propose to show. Let us examine the fatal flaws in the Commissioner's argument.

1. Method of accounting must clearly reflect income, and includes the accounting treatment of any item. So the Regulations say, but what do they mean by any item? Until the recent prepaid interest cases, this theory had not been applied to a single item except in connection with corporations in liquidation, where failure to place certain items on an accrual basis would result in permanent avoidance of income. The cases cited by the Commissioner on page 8 deal with inventory valuation, estimated deductions and automobile dealer reserve accounts, all a far cry from our case and not based on the Commissioner's present theory.

2. The Commissioner has broad powers and the taxpayer a heavy burden in establishing an abuse of discretion. We do not believe these broad powers exist in this case, and therefore urge that this is not an abuse of discretion case, but one involving a clear error of law. If Section 446 means what the Commissioner says, ridiculous results can be (and in this case are) reached. In a penetrating analysis of Burck in the June 1975 issue of the

Journal of Taxation (pp. 326 et seq.) Stanton H. Zarrows and David E. Jordan comment on this point as follows:

> "For example, the court's reference to the fact that Mr. Burck's income for 1969 would have greatly exceeded taxable income in prior years absent the deduction of the prepayment hardly seems a meaningful factor. The court notes that Mr. Burck's 1969 income was 'far in excess' of his income for the years 1967 and 1968. For purposes of illustration, let us assume Mr. Burck's prior taxable income for those years was $100,000 and that, consistent with this pattern, taxable income for 1970 was $100,000. If this be so, allowance of the prepayment produces taxable income in years 1967 through 1970 of $100,000, $100,000, $41,000 and $100,000. Deferral of the deduction produces taxable income of $100,000, $100,000, $419,000 and - $277,000. It seems clear that the distortion-of-income problems inherent in the concept of annual accounting are exacerbated, rather than alleviated, by disallowing a deduction for the prepayment. While allowance of deduction of the prepayment in 1969 reduces $418,000 of taxable income to $41,000, allowance of the deduction in 1970 converts $100,000 income into a $277,000 loss. Moreover, if allowance is postponed until 1970, Section 172, which normally allows carryback of losses to prior years is unavailable, so the distorting effect of disallowing deduction of the prepayment is magnified."

3. The Commissioner's position, as stated in Rev. Rule 68-643 has the blessing of Congress (p.10). The quoted statement was made by the Chairman of the Committee, and certainly cannot have the force of law. Moreover, Congress is now being asked to solve this problem of prepaid interest in the only proper way, by a readily understood statute. A tentative decision of the House Ways and Means Committee would legislate the accrual method ex-

cept in certain specialized, and well defined, cases (Release No. 5). It seems clear that the Commissioner's agonizing over the tax shelter implications of prepaid interest will be short lived.

4. The analogy of other deductions supports the Commissioner. No such support exists. Prepaid rent is disallowed on the theory that it creates a capital asset with a useful life beyond the taxable year (see University Properties, Inc., cited at page 11 of the Commissioner's brief). Prepaid insurance premiums have been disallowed on similar grounds, as the cases cited by the Commissioner hold, not relying on Section 446. Contrary to the Commissioner's assertion, most charges by lenders are now currently deductible as a form of interest. None of these is a distortion of income case under Section 446.

5. Reliance on the Rev. Rul. 68-643 is misplaced. The ruling does not have the force of law. It does not set up adequate standards for the twelve month case. It is not applicable to the Burck facts. The Commissioner dismisses the large capital gain as a fact - not a distortion; but the prepaid interest is also a fact, which happens to restore the balance. And despite the citation of other prepaid interest cases, the fact is that Sandor (Note 8 at page 9 of Commissioner's brief) is really a case where the payment was a "deposit," not a true payment for five years at that, and Cole (Note 9 at page 13) was for 40 months and relied on the absolute prohibition of the Ruling, as well as Sandor.

Moreover, in the Cole case, Judges Hall and Scott concurred in the result, but made it clear that the material distortion test should not be extended to nullify predictability and uniform treatment, and that one year's prepaid interest should be permitted unless and until prohibited prospectively by Congress. This amounts to a dissent from Judge Fay's opinion in the instant case (which was not reviewed by the Tax Court). And in Sandor, the Tax Court said:

> "We also find, however, that the only reason the interest for the full 5-year period was prepaid in 1968 was to give the taxpayer the benefit of a large deduction for interest in a year in which his income was quite high" (emphasis supplied).

This finding would bring this case squarely within the Goldstein doctrine of this Court. But such a finding was specifically abjured by Judge Fay, a fact which we believe binds this Court to a fact pattern which does not involve lack of "purposive activity."

6. At pages 16 to 19 the Commissioner reargues the question whether there was a payment. He says he is entitled to do so; but his leading authority in the Supreme Court held:

> "But even if the Board's decision had been based on an erroneous rule of law, that would not have justified its reversal, if the findings of fact, governed by the correct rule of law, were sufficient to sustain the decision and had substantiated support in the evidence" (emphasis supplied).

Judge Fay held "...petitioner to have prepaid, in cash, interest on certain loans." This is factual, and amply

supported by documentary evidence. The rule of law is plain that Section 163 (a) allows a deduction in 1969. The Commissioner is attempting to say that white is black because black suits his purposes.

7. Throughout his brief, on both points, the Commissioner seems to imply that this is a case of "sham," or no "purposive intent." Of course such an implication is directly refuted by Judge Fay's express statement (see page 15 of Taxpayer's Brief). Had this not been the agreement reached by counsel for the Taxpayer with counsel for the Commissioner in the Tax Court proceeding, ample evidence would have been introduced by the Taxpayer. To imply something that is not the fact is totally unfair to the Taxpayer and his counsel.

In conclusion, we would return to the basic concept of distortion, on which alone the Commissioner's case truly rests. Our research reveals only one case in which the United States Supreme Court considered distortion, The Security Flour Mills Company v. Commissioner of Internal Revenue, 321 U.S. 281 (1944). This case involved a processing tax which, pending conclusion of an action to enjoin collection, the taxpayer had paid into a depository and attempted to deduct. Here the taxpayer attempted to use the clear reflection of income test because it had received the money from its customers in the year of deposit.

The opinion by Mr. Justice Roberts, stated the taxpayer's

position, and the Courts reaction, as follows:

> "Petitioner nevertheless insists that Section 43 of the Revenue Act, which requires that deductions be taken for the taxable year in which the amount was paid or accrued, creates an exception applicable to this case by its concluding clause, 'unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.' In short, the petitioner's position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust or unfair not to isolate the transaction and treat it on the basis of the long term result. We think the position is not maintainable."

The opinion then took up the intent of Congress:

> "From these reports it is clear that the purpose of inserting the qualifying clause was to take care of fixed liabilities payable in fixed installments over a series of years. For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year. But we think it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

Discussing the question of distortion, Justice Roberts said:

"This legal principle has often been stated and applied. The uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount.

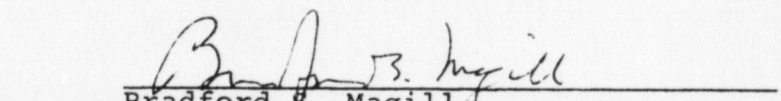
"But the petitioner urges that Section 43 has altered the rule so that a hybrid system, partly annual and partly transactional, may, within administrative discretion, be substituted for that of annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a given year, but, in the light of ultimate gain, from a series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year. The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation."

The final conclusion was:

"We are of the opinion that the purpose of the language which Congress used was not to substitute, whenever in the discretion of an administrative officer or tribunal such a course would seem proper, a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system.

We firmly believe that this is good law, and that the distortion test should not govern a prepayment of interest that was not a sham and not lacking in "purposive intent." It follows that the Tax Court should be reversed on this point.

Respectfully submitted,



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November 26, 1975

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Re: Burck v. Commissioner No. 75-4163

Dear Mr. Fusaro:

We submit herewith for filing in your Court 25 copies of the Reply Brief for the Appellant in the above entitled case. We are forwarding four additional copies to counsel for the appellee, together with a copy of this letter.

Sincerely yours,

Joseph W. Barnett, Jr.

JWB,JR/jgc
Enclosures

cc: Scott P. Crampton,
Assistant Attorney General
Gilbert E. Andrews, Esq.
Elmer J. Kelsey, Esq.
Stanley S. Shaw, Jr., Esq.

ATLANTIC INTERSTATE MESSENGERS, INC. STAMFORD, CONN. 06904

DELIVERY RECEIPT

DATE

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ACCOUNT NO.

ATTN OF

CHARGE

ATTN OF

CHARGE

ICC DELIVERY CHARGES

P.U.C. DELIVERY CHARGES

PICKED UP BY	DELIVERED BY	SPECIAL	MULTIPLE	DECLARED VALUE	INITIALS

TIME ARR.	TIME DEP.	TIME ARR.	TIME DEP.	REGULAR	RETURN	PURCHASE NO.

NO. OF PIECES	DESCRIPTION	WEIGHT	CHARGE NO.

RECEIVED BY

NO INITIALS PLEASE

TIME

DATE

TOTAL CHARGES